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Washington, D. C. 20505

DIRECTORATE OF INTELLIGENCE

16 FEB 1983

MEMORANDUM FOR: The Honorable Beryl W. Sprinkel
Under Secretary for Monetary Affairs
Department of the Treasury

FROM :
Director of Global Issues

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SUBJECT : Proposed IMF Quota Increase

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1. Attached is the analysis you requested on our view of the impact of a failure of the IMF to receive a proposed quota increase. The analysis is necessarily impressionistic; the dollar amounts pale in comparison to borrowers' debt burdens and the depth of their financial problems, but the quotas are key to getting commercial banks to share the cost of debtors' economic adjustment.

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Attachment:

IMF Quota Increases: A Key to
Financial Stability GI M 83-10034,
February 1983,

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GI M 83-10034

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OGI/EOD/IF [] (10Feb83)

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INTERNATIONAL FINANCE: THE IMF QUOTA ISSUE [redacted]

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Summary

The failure of the IMF to increase its lending capacity threatens the smooth resolution of international financial problems and the recovery of industrial economies. The IMF has been playing an untraditionally strong role in forcing cooperation between commercial banks, debtor and creditor governments, and itself. The Fund hopes this coordinated approach will prevent a cutoff in funds needed to maintain economic and political stability in key debtor countries and assure equitable repayment of existing debt. Should the IMF lack the funds necessary to play the lead role in these negotiations, we believe that:

- o *Western banks may pull back sharply from new lending to LDCs. A sudden cutback — rather than a carefully engineered rationing — of new commercial bank credit could cascade into even more serious financing problems.*
- o *A cutoff in new lending would be detrimental to the US economy trying to pull itself out of recession. With LDCs having to slash imports, increasingly important markets for US and other industrial country exports would be jeopardized, especially in Latin America.*
- o *The IMF would be severely handicapped in its primary role of encouraging international economic stability based on the free market principles espoused by the United States and its allies.*
- o *Key advanced LDCs such as Brazil and Mexico, which are increasingly integrated into our Western economic system, could swing their weight toward radical and confrontational Third World schemes for global economic reform.*

This memorandum was prepared by [redacted] Economics Division, Office of Global Issues. Information available as of 9 February 1983 was used. Comments and queries are welcome and may be addressed to the International Finance Branch, Economics Division, Office of Global Issues [redacted]

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INTERNATIONAL FINANCE: THE IMF QUOTA ISSUE

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Background

If, as now envisaged, demands on IMF resources from troubled borrowers continue to mount, the IMF could run out of funds this year. As of yearend 1982 the Fund had some \$30 billion available for new lending but it has committed or is about to commit almost \$25 billion through programs with Mexico, Brazil, Argentina, and other countries, leaving a scant \$5 billion to handle new requests. The IMF may choose not to maintain such ambitious programs by borrowing new funds. In any event it would quickly run into statutory limits on its own borrowing, which cannot exceed 60 percent of the level of quotas.

Quotas, or members' subscriptions, currently account for about two-thirds of the IMF's resources; the remainder are borrowed. Quotas, which also represent the members' voting strength in the organization, are reviewed at least once every five years and revised if necessary. The eighth quota review, now underway, is considering boosting members' subscriptions from about \$65 billion to approximately \$100 billion on the assumption that increased resources will be necessary to meet members' needs for balance of payments assistance through most of the 1980s. If approved, these additional resources probably would become available to the IMF beginning in late 1983 or in 1984. Currently the US quota, about 20 percent of the total, is valued at some \$13.5 billion.

Demands on the IMF

The IMF has assisted a large number of countries that suffered from temporary balance of payments problems. It was able to meet the needs of as many as 60 countries after the first oil shock because (a) the average needs of each country were relatively small; (b) except for drawings in excess of \$1 billion by Italy in 1974 and 1975 and by the United Kingdom in 1976 and 1977, no large borrowers dominated; and (c) special facilities financed outside the quota system met a large share of the borrowing needs.

Pressures to borrow from the IMF are now more severe. The wrenching structural adjustments to global recession that nearly every country is experiencing have put an unprecedented demand on the IMF for financial assistance. In 1982, 64 countries drew nearly \$10 billion from the Fund, with the pace of borrowing accelerating sharply in the fourth quarter. Drawings in 1983 will be even greater as the Fund makes disbursements to borrowers — notably Brazil, Mexico, and Argentina, who were negotiating IMF programs at yearend.

Member Borrowings from the IMF

<u>Year</u>	<u>Countries</u>	<u>Amount</u> (\$ million)	<u>Average</u> (\$ million)	<u>Year</u>	<u>Countries</u>	<u>Amount</u> (\$ million)	<u>Average</u> (\$ million)
1970	41	1,510	37	1977	36	4,010	111
1971	34	1,900	56	1978	33	4,680	142
1972	27	1,760	65	1979	42	2,380	57
1973	25	870	35	1980	49	4,880	100
1974	50	4,860	97	1981	59	8,270	140
1975	54	5,640	104	1982	64	9,660	151
1976	60	8,060	134				

The Indebtedness of Developing Countries

Debt is an important means of generating growth and improved living standards for countries just as it is for corporations and individual citizens. Until the early 1970s, the LDCs had only limited access to international capital markets and relied instead on official aid to finance their development. During the 1970s, the source of financing shifted sharply toward private foreign banks for several reasons.

- o Progressive developing countries such as Brazil, Mexico, South Korea, and Taiwan provided investment opportunities as their economies opened themselves up to global competition.
- o The 1973-74 oil shock increased the demand for bank financing to pay for both higher energy costs and the new investment needed for more energy-efficient industrial production.
- o At the same time, banks had large deposits of OPEC earnings to lend. In part because they were encouraged by their governments to "recycle" these deposits to countries with high oil bills and in part because bank profits depended on competing aggressively for customers, bank lending surged.

Hindsight suggests that the rapid buildup of bank debt during the 1970s was imprudent for both the lenders and the borrowers. It is not clear, however, that any significant cautionary signals were available at the time.

- o Despite higher oil prices, LDC economies continued to expand rapidly. For the non-oil-exporting LDCs, growth averaged nearly six percent annually in 1973 through 1979, about twice the rate of growth for the industrial countries.
- o Global inflation was making repayment easier by eroding the real value of debt balances.
- o Not only were opportunities for bank profits high in the LDCs, but the record of loan losses was much better than that for domestic borrowers.

These favorable conditions changed abruptly beginning in 1979. Oil prices soared from an average of \$13 per barrel in 1978 to \$33 per barrel by the end of 1980. Industrial country governments began to attack inflation by restrictive monetary policies that boosted interest rates, and hence debt service costs, and reduced the demand for LDC exports. Adjustment to this changed situation was gradual — perhaps too gradual in some cases — and LDC current account deficits began to widen sharply. Confidence in the way the first oil shock was handled probably led most governments and bankers to believe that often-promised industrial country recovery was just around the corner. For their part, bankers probably continued to expand lending to cover these current account deficits in hopes of protecting their loan portfolios. The combination of a rapid buildup of debt and a marked deterioration in debt servicing capacity set the stage for the financial problems that exist today.

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Need for Lengthy Adjustment

We do not expect demands on the IMF to abate for several years. Widely publicized, multi-billion dollar emergency credits for such countries as Mexico, Brazil, and Argentina are effective short-term measures to meet immediate cash crises, prevent default, and initiate programs of financial conservatism; but they do not clear up the underlying debt problems of these and other countries immediately. It will take perhaps three to four years of sustained effort for major borrowers to restore their creditworthiness, regain normal access to financial markets, and resume robust economic growth.

Slow Recovery from Global Recession

The persistent and worsening financial situation of the LDCs is closely tied to the global recession that is now well-into its third year. The LDCs are faced with two distinct but related problems:

- o LDC exporters have been hit by a collapse of commodity prices without any rise in industrial country demand. Eight of the 12 Third World countries with the most serious debt problems suffered major declines in export earnings last year, while the others experienced sharp drops in the growth of export earnings. Ivory Coast, Jamaica, Kenya, and the Philippines have had their exports reduced for two or more years in a row.
- o High interest rates have greatly increased debt service obligations. The interest premium on most loans is linked to the London Interbank Offer Rate or to the US prime rate. The nearly 5 percentage point rise in interest rates that took place over 1980 and 1981 added some \$10 billion in debt service costs to LDCs during that period. The burden of interest payments rose to over a quarter of the total foreign earnings for such countries as Mexico, Brazil, Chile, and Argentina.

Any acceleration in the pace and timing of economic recovery in the industrial countries would provide the LDCs with needed breathing room, in part because it would provide the banking community with a signal that LDC export prospects will improve and that the LDCs are in a better position to handle their debts. The direct gains from a more rapid OECD expansion will not be felt immediately and will not be evenly distributed among the troubled debtors. Some will benefit sooner than others and some more than others. In our judgment, most of the initial pickup in economic activity will be concentrated in the consumer sector. Increased demand for LDC raw materials will take considerably longer to materialize in part because of the large inventory overhang for many raw materials.

Altogether, we would expect a delay in LDC export responses to stronger OECD growth of anywhere from six months to a year. For some commodities the delay will be appreciably longer. OECD demand for key LDC agricultural exports such as sugar is not sensitive to the industrial country business cycle. Beyond this, the excess capacity available for most industrial materials sold by LDCs would dampen much of the price response. Because of these capacity overhangs, we believe competition among producers would limit the speed of price recovery.

This is not to say that the business cycle advantages to all LDCs will develop slowly. If past cycles are a guide, the LDCs that produce consumer-oriented goods will

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capitalize quickly on Western recovery. South Korea, Hong Kong, Taiwan, and Singapore — countries in relatively healthy financial position — would be the chief gainers. To some extent this pattern of demand would also benefit Mexico and Brazil, so long as they have access to supplier credits.

Further Shocks Likely

While this OECD-growth-led recovery is taking place the IMF may have to handle additional shocks brought on by the adjustment process itself. An unprecedented number of countries with complex international linkages will all be attempting to reform their economies over the same period. Taken individually, the prospects that each country could smoothly adjust under the aegis of the IMF are good; together, adjustment raises new problems. In 1981, for example, Brazil and Argentina each sold about 20 percent of their exports to other South American countries and purchased about 15 percent of their imports from them. Bolivia, Paraguay, and Uruguay probably will find it increasingly difficult to meet debt payments and import bills because of their heavy dependence on sales to troubled neighbors.

Moreover, IMF help might be needed to handle any shocks that may arise from an uncertain oil market over the next several years. Mexico, for example, could lose over \$5 billion in foreign earnings if oil prices fall to \$20 per barrel. Without compensating financing, Mexico would have to cut back imports by that amount on top of initial plans for no growth of imports beyond the \$15 billion level of last year, which was already down 40 percent from 1981. Nigeria, Venezuela, and Indonesia will be running into increasingly serious financial constraints this year even if oil prices remain steady. If prices decline to \$20 per barrel, these countries would have a combined drop in earnings of \$17 billion. We do not believe that foreign bankers would be willing to increase exposure in these countries much, if at all. None of these countries has much maneuvering room; all have been drawing down their reserves substantially in recent months to pay for needed imports and debt servicing.

The adjustments demanded by the IMF and private creditors have high political and economic costs, which are in part held in check by the assurance of continued IMF support if needed and by the opportunity for national governments to share the onus of adjustment with a faceless but respected partner. In the absence of such discipline, we believe that political pressure could force governments to abandon adjustment programs, thereby sacrificing the longer term development of their countries. The prospects for this are probably highest in such countries as Argentina and Mexico with highly nationalist governments. To the extent that governments are unable to make managed adjustments and resort to politically popular but unsustainable domestic expansion, the opportunities increase for rash policies — such as military moves against neighbors — and Soviet mischief.

If the IMF is shut out of the global adjustment process because of insufficient funding, the ability of the complex global economy to wrestle with unforeseen shocks would be substantially reduced. The growth in international trade and investment flows since the end of World War II has been facilitated by the Fund's ability to overlay the global economic system with currency convertibility, liquidity management, and exchange rate stability. The global economy in the remainder of the 1980s is not guaranteed to be free from such shocks as widely differing growth and inflation rates among countries, changing commodity prices, or future energy or strategic material crises.

The Demonstration Effect of IMF Participation

Even though a quota increase would probably not show up on the IMF's books until late 1983 or in 1984, its authorization would boost the sagging confidence of commercial lenders that the Fund will continue to back adjustment programs that will help debtors generate a manageable stream of debt repayments. For the next few months, major US and other industrial country banks may again be called on to provide a quick infusion of cash to these borrowers to avert a crisis. Emergency loans by large banks, however, will only provide a temporary solution to South American debt problems. If the smaller institutions continue to reduce their lending, debt service could become unmanageable without full IMF participation.

IMF programs — which include plans for restructuring financially troubled economies and monitoring their progress — are the key to convincing foreign private banks to share the cost of the economic adjustments the LDCs must make. The IMF programs recently under negotiation are associated with a substantial amount of new bank lending. The Fund's involvement and leverage over debtor countries have been crucial to getting commercial banks to continue to provide credit when it is needed most to ease the adjustment process.

New Lending Associated with IMF Programs

<u>Country</u>	<u>Estimated Debt Yearend 1982 (\$ billion)</u>	<u>IMF Package (\$ billion)</u>	<u>New Lending Associated with IMF Package (\$ billion)</u>
Argentina	40	2.2	1.5
Brazil	87	5.5	4.4
Mexico	83	3.9	5.0
Yugoslavia	19	0.5*	1.0

* Third year of the 1981-83 stand-by arrangement.

The unanticipated flight of commercial banks could easily result in a repeat — albeit on a smaller scale — of Brazil's current financial difficulties. During much of the past decade Brazil had a reasonably well-managed economy. It had been developing alternative energy sources to reduce its dependence on expensive imported oil, expanding and diversifying its exports, and adjusting its economic growth to the realities of financing availability. While its debt was the largest in the Third World, Brazil was on its way to becoming a developed country capable of managing its financial burden.

The Mexican financial crisis shocked bankers into believing that their loans to all Latin American borrowers were at risk. After smoothly arranging some three quarters of the financing needed to pay its balance of payments gap last year, Brazil's foreign credit slowed sharply in September. Brazil began to have serious difficulty obtaining loans from major banks, and smaller banks began to refuse new loan requests and to demand payment of maturing short-term credit. With access to credit cut off, little reserve cushion, and depressed export earnings, Brazil was unable to meet its daily foreign exchange requirements.

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Other countries are also vulnerable to a credit contraction that could be precipitated by a lack of confidence that the IMF will continue to lead in solving debtors' cash problems.

- o Chile's financial position, already weakened by a decline in exports, capital flight, and a slowdown in new lending, turned critical after bankers stopped credit operations in a recent financial dispute with the government.
- o Venezuela is increasingly vulnerable to a loss of banker confidence because of its poor economic and financial management, high short-term debt, dwindling reserves, and uncertain oil export prospects. International lenders are shying away from new loans, undermining the government's plans to refinance short term public debt. Failure to refinance these could lead to debt rescheduling.
- o Argentina is vulnerable to another credit contraction because of its need to arrange new financing to roll over maturing debt. Smaller US banks may be especially unwilling to renew lending necessary to finance exports and purchase needed imported industrial supplies.
- o Peru is having difficulty in obtaining longer term credits, despite its willingness to pay higher rates.
- o The Philippines is beginning to encounter stiffer terms on new loans, and some banks are reviewing their exposure more critically and moving toward more short-term positions.
- o The smaller industrial countries are not immune either; we are beginning to see some signs that Portugal and Greece are having financial problems.

Impact on Western Trade and Recovery

Countries unable to secure financing to cover their current account deficits would be left with two choices, both of which threaten the economic recovery of the United States. They could further dramatically cut back imports with adverse consequences on growth, living standards, and political stability. With or without a further import squeeze, some countries could decide to claim a payments moratorium and try to manage trade on a barter basis or pay on cash flow from current exports.

Troubled debtors are already curbing import growth to bring their current account balances more in line with the availability of financing. Mexico's IMF accord, for example, will allow it to avoid a second year of precipitous decline in imports in 1983; even so, imports will be down to some \$15 billion from \$24 billion in 1981. If Mexico loses IMF support, however, we estimate that imports could drop as low as \$10 billion.

The bulk of LDC import cutbacks will fall on the industrial countries. The OECD sold more than \$300 billion worth of goods to LDCs in 1981, up from only \$40 billion a decade earlier. Sales to LDCs constitute about 40 percent of total US exports; the 25 key financially troubled LDCs together purchased \$55 billion in manufactures from the industrial countries in 1981, almost \$30 billion of which came from the United States. This was nearly one-fifth of the total overseas market for US manufactures. Almost 10 percent of our manufactures exports are to Mexico alone.

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Several recent studies have tried to capture the impact on the OECD countries in the aggregate of a fall in exports to the LDCs that could be caused by, for example, a cutback in bank lending to the LDCs. If bank lending is cut by \$25 billion:

- o A Morgan Guaranty Trust Company analysis indicates that OECD growth would fall at least 0.5 percentage point.
- o An OECD Secretariat analysis indicates that OECD growth would be off by 0.6 percentage point.
- o An analysis drafted by the Council of Economic Advisers indicates that if the \$25 billion credit cutback is allocated just to Argentina, Brazil, Chile, Mexico, Peru, and Venezuela, GNP of the United States alone would fall 0.9 percentage point because of the strong trade linkages between the United States and Latin America.

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The European View

West European leaders were generally in favor of greater increases in the IMF's lending capability than the United States. Initially some major European countries were sympathetic to increases of about 65 percent. The European negotiating position last week was for a 50 percent increase, or 10 percentage points higher than the United States' initial position. West Europeans subscribe to the idea that IMF resources must be augmented to improve the debt service capability of troubled borrowers in the absence so far of a strong economic recovery in the West. They further believe that the IMF is the key organization to bring debtors to make necessary financial adjustments, and that the IMF is in a strong position to persuade private banks to maintain their exposure. []

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The West European governments probably feel that the 47.5 percent quota increase that emerged was the best that could be achieved under current economic conditions and the political mood in the United States. West Europeans believe the quota increase will be adequate for only about three years and that the five-year review process will need to be replaced by another three-year review. The West Europeans view the immediate need for liquidity as great and they fear that the end-of-year deadline for implementing the quota increase is not soon enough; nonetheless, they strongly oppose IMF borrowing in the private markets to fill the gap. []

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The European reaction to a failure of the US Congress to ratify the US share of the quota increase would likely be dramatic. Any backing away by the United States to support the quota increase would be viewed by West European governments as a reversal of the present policy of working together for a coordinated response to international financial problems. West European bankers would likely echo this criticism and tighten credit across the board in self defense. []

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So far we have not seen any evidence that European capitals consider the increase in the US quota in doubt. We think they foresee a contentious Congress giving a tough time to Administration representatives, but probably calculate that the Congress will eventually view approval in the United States' best interest. []

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